Supreme Court, U.S.
FILED
APR 2 1992
OFFICE OF THE CLERK

No. 91-381

In the Supreme Court of the United States

OCTOBER TERM, 1991

PEOPLE OF THE STATE OF ILLINOIS ex rel.
OFFICE OF PUBLIC COUNSEL, PETITIONER

v.

ILLINOIS COMMERCE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE ILLINOIS SUPREME COURT

BRIEF FOR THE UNITED STATES AND THE FEDERAL ENERGY REGULATORY COMMISSION AS AMICI CURIAE

KENNETH W. STARR
Solicitor General

EDWIN S. KNEEDLER
Assistant to the Solicitor General

STEPHEN L. NIGHTINGALE
Assistant to the Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 514-2217

WILLIAM S. SCHERMAN
General Counsel

JEROME M. FEIT
Solicitor

RANDOLPH LEE ELLIOTT
Attorney
Federal Energy Regulatory Commission
Washington, D.C. 20426

QUESTION PRESENTED

Acting pursuant to the Natural Gas Act, 15 U.S.C. 717 *et seq.*, the Federal Energy Regulatory Commission authorized interstate gas pipelines to recover from their customers a portion of the amounts the pipelines have paid to settle liability under take-or-pay provisions in their contracts with gas producers. In proceedings before the Illinois Commerce Commission, the pipelines' customers sought to pass through, to their retail customers, the amounts FERC's orders allowed the pipelines to recover. The question presented is:

Whether principles of federal preemption—in particular, the filed rate doctrine—obligate the Illinois Commerce Commission to allow the pipelines' customers to pass through the full amount of the take-or-pay charges imposed on them.

TABLE OF CONTENTS

	Page
Statement	1
1. FERC's jurisdiction under the Natural Gas Act	1
2. FERC's open-access policy	2
3. The Commission's response to the take-or-pay problem	3
4. Proceedings in this case	7
Discussion	11
Conclusion	21

TABLE OF AUTHORITIES

Cases:

American Gas Ass'n v. *FERC*, 888 F.2d 136 (D.C. Cir. 1989)	4
American Gas Ass'n v. *FERC*, 912 F.2d 1496 (D.C. Cir. 1990), cert. denied, 111 S. Ct. 957 (1991)	4
Arkansas Louisiana Gas Co. v. *Hall*, 453 U.S. 571 (1981)	12
Associated Gas Distributors v. *FERC*, 824 F.2d 981 (D.C. Cir. 1987), cert. denied, 485 U.S. 1006 (1988)	3
Associated Gas Distributors v. *FERC*, 893 F.2d 349 (1989), cert. denied, 111 S. Ct. 277 (1990)	4, 6, 18
Association of Businesses Advocating Tariff Equity (ABATE) v. *Michigan Public Serv. Comm'n*, No. 129564 (Mich. Ct. App. Nov. 18, 1991)	16
Delmarva Power & Light Co., In re, 116 P.U.R.4th 287 (Del. P.S.C. 1990)	17
EnergyNorth Natural Gas, Inc., In re, 122 P.U.R. 4th 449 (June 3, 1991), reh'g denied, 124 P.U.R. 4th 160 (N.H. P.U.C. July 1, 1991)	17
FPC v. *Southern California Edison Co.*, 376 U.S. 205 (1964)	14
Fidelity Federal Savings & Loan Ass'n v. *de la Cuesta*, 458 U.S. 141 (1982)	16

Cases—Continued: Page

General Motors Corp. v. *Public Service Comm'n*, 589 A.2d 982 (Md. Ct. Spec. App. 1991) 16
Hamm v. *South Carolina Public Serv. Comm'n*, No. 89-CP-40-0625 (S.C. Ct. Comm. Pl., Richland County June 10, 1991) 17
Hamm v. *South Carolina Public Serv. Comm'n*, No. 91-797 (S.C. Sup. Ct. argued Feb. 3, 1992) 17
Kentucky West Virginia Gas Co. v. *Pennsylvania Public Utility Comm'n*, 837 F.2d 600 (3d Cir.), cert. denied, 488 U.S. 941 (1988) 13
Mechanisms for Passthrough of Pipeline Take-or-Pay Buyout and Buydown Costs:
Order No. 528, 55 Fed. Reg. 47,863 (1990) 6, 7, 18, 19, 20
Order No. 528-A, 54 F.E.R.C. ¶ 61,095 (1991) 6
Order No. 528-B, 55 F.E.R.C. ¶ 61,372 (1991), appeal pending *sub nom. Tennessee Gas Pipeline Co.* v. *FERC*, No. 91-1069 (D.C. Cir.) 6
Mississippi Power & Light Co. v. *Mississippi*, 487 U.S. 354 (1988) 7, 8, 10, 13, 14, 15
Mobil Oil Exploration & Producing Southeast, Inc. v. *United Distribution Cos.*, 111 S. Ct. 615 (1991) 3
Montana-Dakota Utilities Co. v. *Northwestern Public Serv. Co.*, 341 U.S. 246 (1951) 12
Nantahala Power & Light Co. v. *Thornburg*, 476 U.S. 953 (1986) 9, 13
Narrangansett Electric Co. v. *FERC*, 381 A.2d 1358 (R.I. 1977), cert. denied, 435 U.S. 972 (1978) 13
Northern Indiana Public Serv. Co., In re, 97 P.U.R.4th 1 (Ind. U.R.C. 1988) 17
Northwest Central Pipeline Corp. v. *Kansas Corp. Comm'n*, 489 U.S. 493 (1989) 14
Pike County Light & Power Co. v. *Pennsylvania Public Utility Comm'n*, 465 A.2d 735 (Pa. Commw. 1983) 13

Cases—Continued: Page

Planning Review, Rate Design, Purchased Gas Adjustment Clauses, Accounting, and Related Matters for Natural Gas Distribution Utilities, In re, 99 P.U.R.4th 253 (Wis. P.S.C. 1989) 17
Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Order No. 436, 50 Fed. Reg. 42,408 (1985) vacated and remanded *sub nom. Associated Gas Distributors* v. *FERC*, 824 F.2d 981 (D.C. Cir. 1987), cert. denied, 485 U.S. 1006 (1988) 2, 3, 4
Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol (Order Nos. 500 to 500-I):
Order No. 500, 52 Fed. Reg. 30,334 (1987) 3, 4, 5, 6, 7, 8, 15
Order No. 500-H, 54 Fed. Reg. 52,344 (1989) 3, 4, 5, 7
Order No. 500-I, 55 Fed. Reg. 6605 (1990) 4, 6, 7
Schneidewind v. *ANR Pipeline Co.*, 485 U.S. 293 (1988) 14
Southern California Gas Co., In re, 109 P.U.R.4th 1 (Cal. P.U.C. 1990) 17
Transcontinental Gas Pipe Line Corp. v. *State Oil & Gas Bd.*, 474 U.S. 409 (1986) 3
Transwestern Pipeline Co. v. *FERC*, 897 F.2d 570 (D.C. Cir. 1990) 4

Statutes:

Federal Power Act, 16 U.S.C. 791a *et seq.* 12
Natural Gas Act, 15 U.S.C. 717 *et seq.* 12
§ 1(b), 15 U.S.C. 717(b) 1, 2, 6, 12
§ 4, 15 U.S.C. 717c 12
§ 4(c), 15 U.S.C. 717c(c) 12
§ 5(d), 15 U.S.C. 717d(a) 12
Natural Gas Policy Act of 1978, 15 U.S.C. 3301 *et seq.* 2

In the Supreme Court of the United States

OCTOBER TERM, 1991

No. 91-381

PEOPLE OF THE STATE OF ILLINOIS ex rel.
OFFICE OF PUBLIC COUNSEL, PETITIONER

v.

ILLINOIS COMMERCE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE ILLINOIS SUPREME COURT

BRIEF FOR THE UNITED STATES AND THE FEDERAL ENERGY REGULATORY COMMISSION AS AMICI CURIAE

This brief is submitted in response to the Court's order inviting the Solicitor General to file a brief expressing the views of the United States.

STATEMENT

1. *FERC's Jurisdiction Under the Natural Gas Act*

Under Section 1(b) of the Natural Gas Act, 15 U.S.C. 717(b), the Federal Energy Regulatory Commission (FERC) exercises exclusive regulatory authority over

> the transportation of natural gas in interstate commerce, * * * the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and * * * natural-gas companies engaged in such transportation or sale * * *.

The Act preserves state authority over "any other transportation or sale of natural gas," "the local distribution of natural gas," "the facilities used for such distribution," and "the production or gathering of natural gas." *Ibid.*

2. *FERC's Open-Access Policy*

In the 1980s, FERC exercised its authority to promote a major restructuring of the natural gas industry. Before that time, most natural gas was sold by producers to gas pipelines and then was resold by the pipelines to local distribution companies (LDCs), which serve consumers and industrial users, or to other pipelines or end users. LDCs were usually unable to purchase gas directly from producers. Many geographic areas were served by only a single pipeline, and a pipeline holding such a market position was generally unwilling to transport natural gas in competition with its own sales.

In 1985, however, FERC issued its Order No. 436.[1] The objective of the order was to facilitate "open access" to all interstate pipelines, so that LDCs and others could purchase natural gas directly from producers and employ the pipelines to transport it. FERC's primary goal was to increase the extent to which natural gas sales were exposed to market forces. The open-access policy generally had its intended effect. When Order No. 436 was issued, there was a surplus of natural gas at the wellhead—resulting from the phased deregulation of wellhead prices under the Natural Gas Policy Act of 1978, 15 U.S.C. 3301 *et seq.*, and other economic factors. LDCs and others were able to contract for those supplies directly with gas suppliers on the "spot market" and engage pipelines to transport the gas. Wholesale customers (such as LDCs) of the pipelines were thus able to realize the benefits of increased access to competitively priced supplies.

---

[1] Order No. 436, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, 50 Fed. Reg. 42,408 (1985).

One consequence of those changes in the natural gas industry, however, was that many gas pipelines were faced with major liabilities under "take-or-pay" clauses in their contracts with natural-gas producers. A take-or-pay clause obligates a pipeline to pay for a certain amount of gas at a specified price, even if the pipeline does not actually take delivery of the gas. See *Transcontinental Gas Pipe Line Corp.* v. *State Oil & Gas Bd.*, 474 U.S. 409, 412 (1986). Between 1977 and 1982, when the price of natural gas was much higher than it is today and supplies were tight, many pipelines agreed to take-or-pay clauses in order to secure access to supplies sufficient to serve the anticipated demand of their customers.

As a result of the increased supplies and lower prices prevalent in the market by the mid-1980s, pipelines' customers—principally LDCs—had little incentive to purchase gas from pipelines at prices sufficient to cover the prices the pipelines had agreed to pay in their take-or-pay contracts. As a result, by 1987, the pipelines faced billions of dollars of accrued take-or-pay liability and future take-or-pay exposure. See *Mobil Oil Exploration & Producing Southeast, Inc.* v. *United Distribution Cos.*, 111 S. Ct. 615, 627 (1991).[2]

3. *The Commission's Response to the Take-or-Pay Problem*

In 1987, the D.C. Circuit rejected a variety of challenges to FERC's Order No. 436, but held that the Commission had failed adequately to address the effects of the open-access policy on the pipelines' take-or-pay exposure. See *Associated Gas Distributors* v. *FERC*, 824 F.2d 981, 996, 1021-1030 (1987), cert. denied, 485 U.S. 1006 (1988). On remand, the Commission issued a series of orders, beginning with Order No. 500,[3] that retained

---

[2] See also Order No. 500-H, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, 54 Fed. Reg. 52,344, 52,348, 52,356 (1989).

[3] Order No. 500, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, 52 Fed. Reg. 30,334 (1987). Order No.

Order No. 436's open-access provisions but also instituted a policy of "equitable sharing" of take-or-pay liability across the natural-gas industry. With those orders, the Commission sought to encourage both producers and pipelines to absorb a portion of the unresolved take-or-pay liability and to provide for a fair allocation of the remaining liability among the pipelines' customers.

a. Order No. 500 encouraged producers and pipelines to enter into settlements under which the pipelines would "buy down" their existing take-or-pay contracts by reforming their provisions and "buy out" their accrued liability under those contracts. In those settlements, pipelines obligated themselves to pay substantial sums to producers.[4]

b. Order No. 500 also encouraged pipelines to absorb a portion of the buy-out and buy-down costs they incurred, rather than passing them on to their customers. Under traditional FERC ratemaking procedures, a pipeline would generally be entitled to recover prudently incurred costs by means of a surcharge on rates charged on current gas sales. Order No. 500 preserved that option, but many pipelines maintained that its usefulness was limited under prevailing market conditions. Because

---

500 was an interim order; it was supplemented by a series of additional orders, Order Nos. 500-A to 500-I. The final rule regarding the resolution of take-or-pay exposure was Order No. 500-H, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, 54 Fed. Reg. 52,344 (1989), aff'd on reh'g, Order No. 500-I, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, 55 Fed. Reg. 6605 (1990). These orders, in turn, have been the subject of a series of decisions by the D.C. Circuit. *American Gas Ass'n* v. *FERC*, 888 F.2d 136 (1989); *Associated Gas Distributors* v. *FERC*, 893 F.2d 349, 355 (1989); cert. denied, 111 S. Ct. 277 (1990); *Transwestern Pipeline Co.* v. *FERC*, 897 F.2d 570 (1990); *American Gas Ass'n* v. *FERC*, 912 F.2d 1496 (1990), cert. denied, 111 S. Ct. 957 (1991). For ease of reference, we will refer to this series of orders as "Order No. 500," except where a more specific reference is appropriate.

[4] Order No. 500, 52 Fed. Reg. at 30,338-30,341; Order No. 500-H, 54 Fed. Reg. at 52,358-52,387.

of increased competition for gas sales, if a pipeline set its rates high enough to cover its take-or-pay settlement costs, it would run the risk of being unable to locate buyers at those rates.[5]

Recognizing those economic considerations, Order No. 500 provided pipelines an alternative that virtually all pipelines chose to use. If a pipeline agreed to absorb—not pass through—between 25% and 50% of its take-or-pay costs, Order No. 500 authorized it to recover an equal amount by means of a direct, fixed charge to its past sales customers, rather than an additional charge on current sales of gas.[6] Such a fixed charge, unlike a surcharge, would not increase the current price of the pipeline's natural gas. Thus, its effectiveness as a means of recovering take-or-pay settlement costs would not depend on locating a willing buyer at an increased price.[7]

c. In exercising its authority to approve tariffs providing for recovery of fixed take-or-pay charges, FERC was called upon to determine how much of those charges each customer of a pipeline would be required to pay. Initially, FERC employed the "purchase deficiency" method for that purpose. Under this approach, the pipeline compared each customer's cumulative gas purchases in a period after the open-access policy had taken effect (the so-called "deficiency period") with its purchases during a representative period before that policy had been implemented (the "base period"). The pipeline then allocated the direct-billed portion of its take-or-pay costs to each customer in proportion to the decline in that customer's purchases during the deficiency period. Under this system, pipeline customers who reduced their pur-

---

[5] Order No. 500, 52 Fed. Reg. at 30,341-30,346; Order No. 500-H, 54 Fed. Reg. at 52,387.

[6] Order No. 500, 52 Fed. Reg. at 30,341. The pipeline could also seek to recover the remaining percentage of its take-or-pay liability, if any, by means of a volumetric surcharge on both sales and transportation of gas. *Ibid.*

[7] Order No. 500-H, 54 Fed. Reg. at 52,387.

chases from the pipeline to buy less costly gas at the wellhead would bear a greater share of the cost of resolving the pipeline's take-or-pay liability than would customers whose purchase levels remained relatively constant.[8]

In *Associated Gas Distributors* v. *FERC*, 893 F.2d at 355, the D.C. Circuit struck down the purchase deficiency method. The court reasoned that the use of that method was tantamount to a retroactive rate increase for previous sales of gas and was thus a violation of the filed rate doctrine. This Court denied certiorari. 111 S. Ct. 277 (1990). FERC then issued Order No. 528, which stayed the effectiveness of tariffs employing the purchase deficiency method (except where a FERC order approving such an allocation had become final and nonappealable).[9] Order No. 528 did not prescribe any particular substitute for the purchase deficiency method. Rather, it set forth broad principles by which FERC would assess allocation methods proposed by particular pipelines, described several acceptable alternatives, and encouraged pipelines and their customers to negotiate arrangements to replace the purchase deficiency method.

d. The Natural Gas Act preserves state authority over "local distribution of natural gas," 15 U.S.C. 717(b). Consequently, Order No. 500 did not attempt "to prescribe the methods by which approved pipeline take-or-pay costs are to be allocated at the state level"—*i.e.*, the extent to which LDCs could pass on take-or-pay charges to their customers.[10] The Commission did, however, express

---

[8] Order No. 500, 52 Fed. Reg. at 30,351-30,352; Order No. 500-I, 55 Fed. Reg. at 6621.

[9] Order No. 528, *Mechanisms for Passthrough of Pipeline Take-or-Pay Buyout and Buydown Costs*, 55 Fed. Reg. 47,863 (1990), reh'g granted in part and denied in part, Order No. 528-A, 54 F.E.R.C. ¶ 61,095 (1991), reh'g denied, Order No. 528-B, 55 F.E.R.C. ¶ 61,372 (1991), appeal pending *sub nom. Tennessee Gas Pipeline Co.* v. *FERC*, No. 91-1069 (D.C. Cir. filed Feb. 8, 1991).

[10] Order No. 500, 52 Fed. Reg. at 30,344.

the view that "there should be an equitable sharing of take-or-pay costs among all segments of the industry," and that state regulatory agencies are not preempted by federal law "from designing LDC rates, or, in appropriate circumstances, from reviewing the prudence of LDCs' purchasing decisions insofar as they affect take-or-pay costs." [11]

4. *Proceedings in This Case*

a. In April 1988, the Illinois Commerce Commission began an investigation into the "appropriate recovery by Illinois gas utilities of costs associated with take-or-pay charges from interstate pipeline companies." Pet. App. A74. Throughout the Illinois Commission's proceeding, the direct charges made by interstate pipelines were computed pursuant to the "purchase deficiency" method; the D.C. Circuit's decision in *Associated Gas Distributors* disapproving that methodology was not issued until after the Commission entered its final order. Illinois LDCs and representatives of Illinois residential and industrial energy consumers, including petitioner Office of Public Counsel, were parties to these proceedings before the Illinois Commission.

In an interim order, the Illinois Commission addressed the question whether it was "required, as a matter of law, to allow gas utilities subject to its jurisdiction to recover

---

[11] Order No. 500, 52 Fed. Reg. at 30,344 (quoted at Pet. App. A54-A55). Accord Order No. 500-H, 54 Fed. Reg. at 52,387-52,388; Order No. 500-I, 55 Fed. Reg. at 6622-6623. The Commission expressed a similar view in Order No. 528, 55 Fed. Reg. at 47,865.

A prudence review is a customary aspect of utility ratemaking. When a regulated utility seeks to include costs incurred in supplying natural gas (or electricity) to be recovered from its customers, its regulator may generally consider whether those costs have been prudently incurred. If the regulator concludes that the costs were the result of imprudence, it may disallow them, effectively reducing the rate of return realized by the utility's shareholders. See, *e.g.*, *Mississippi Power & Light Co.* v. *Mississippi*, 487 U.S. 354, 366-368 (1988).

pipeline take-or-pay costs billed under the so-called direct-billing mechanism authorized by FERC Order No. 500." Pet. App. A76; see *id.* at A73-A89. The Commission concluded that this Court's decision in *Mississippi Power & Light Co.* v. *Mississippi*, 487 U.S. 354 (1988), "precludes state regulatory agencies from disallowing recovery of direct billed FERC-allocated past take-or-pay costs in retail rates, and precludes such agencies from conducting prudence reviews relating to such costs." Pet. App. A84.[12] The Commission reaffirmed that determination in its final order. *Id.* at A97, A121-A122.

b. By a 2-1 vote, the Illinois Appellate Court for the Fourth District reversed. Pet. App. A33-A72. The court noted that state laws and administrative regulations may be preempted in any of three ways: (1) when the language of a federal statute "specifically preempts State regulation of the subject matter"; (2) when Congress or a federal agency has "indicate[d] an intention to occupy the entire field of regulation"; or (3) when compliance with both state and federal law is impossible or state regulation poses an obstacle to accomplishment of the purpose of federal regulation. *Id.* at A51. Applying those principles to this case, the court first determined that "the congressional intent in enacting the Natural Gas Act was to generally leave to State regulatory agencies the regulation of the rates of LDC's." *Id.* at A54. Second, the court found that FERC's Order No. 500 "manifested an intention *not* to preempt State regulatory agency decisions which might require LDC's to share with rate payers (*i.e.*, absorb) a portion of their take-or-pay costs," adding that "FERC's interpretation of its authority * * * is entitled to deference." *Id.* at A56. Third, the court concluded that it would be possible for LDCs to comply

---

[12] In *Mississippi Power*, this Court held that a state regulatory commission could not disallow amounts that members of an interstate public utility holding company system were required to pay for power produced by a nuclear power plant, when FERC orders obligated each member of the system to purchase specified shares of that power at specified rates. See pp. 13-15, *infra*.

"with both FERC regulations governing take-or-pay costs and a State administrative agency regulation or decision requiring LDC's to absorb some of their take-or-pay costs," and that such a state decision would not "frustrate a purpose or goal of Congress [or] FERC." *Id.* at A57.

The Illinois Appellate Court rejected the LDCs' contention that this Court's decisions in *Mississippi Power* and *Nantahala Power & Light Co.* v. *Thornburg*, 476 U.S. 953 (1986), necessarily entitled the LDCs to pass on all of their fixed take-or-pay charges. In those cases, the court explained, "there was a readily apparent intention on the part of FERC to preempt the entire field of allocation of power produced by interstate electricity pools," whereas here "FERC manifested an intention not to preempt action by the State regulatory agencies requiring LDC's to absorb portions of their take-or-pay costs." Pet. App. A58-A59.

"[T]he fact that LDC's have no present choice but to pay the take-or-pay costs billed to them," the Illinois Appellate Court continued, "does not necessarily mean they should be permitted full recovery of these costs." Pet. App. A62-A63. The court posited a situation in which an LDC's "[p]ast actions"—such as its "choice of a natural gas supplier which subsequently incurred high take-or-pay charges"—might have "influenced the amount of these costs," and it reserved the question whether such an LDC "should be denied full recovery of its take-or-pay costs, because of lack of prudence at the time that choice was made." *Id.* at A63. The court left open for the Illinois Commerce Commission to decide whether its prior annual reviews of the prudence of utilities' fuel purchases would preclude the Commission, as a matter of state law, from even conducting later prudence reviews of the same purchases. *Id.* at A63-A64. The court therefore ordered the case remanded to the Illinois Commerce Commission, directing the Commission to admit evidence pertaining to "(a) the sharing of the take-or-pay costs

of LDC's between the LDC's and rate payers and (b) the factors relevant to the prudence of past purchasing practices of the LDC's as they relate to take-or-pay costs." *Id.* at A64.

c. The Illinois Supreme Court reversed and reinstated the Illinois Commission's order. Pet. App. A1-A32. Relying on this Court's decisions in *Nantahala* and *Mississippi Power*, the court held that "fundamental principles of Federal preemption, as reflected in the * * * filed rate doctrine, prohibit the [state commission] from conducting prudence reviews of FERC-mandated take-or-pay costs" and, accordingly, that Illinois LDCs "must be allowed to pass through to their customers the full amount of these charges." *Id.* at A32; see *id.* at A14-A19. The court rejected the contention, advanced by petitioner and others, that FERC's views favoring the equitable allocation of take-or-pay costs and recognizing the authority of state commissions to review the prudence of incurring take-or-pay costs were dispositive. *Id.* at A19-A26. Regardless of FERC's position, the court reasoned, "the intent of Congress is clear and controlling: 'States may not bar regulated utilities from passing through to retail consumers FERC-mandated wholesale rates.' " *Id.* at A25-A26 (quoting *Mississippi Power*, 487 U.S. at 372).

The court found that *Mississippi Power* and *Nantahala* foreclose any state review of the prudence of past actions by LDCs that subsequently caused them to be allocated take-or-pay costs through direct charges, computed under the purchase deficiency method. Pet. App. A26-A32. The court recognized that "States retain the authority to review the prudence of a distributor's actions in incurring FERC-approved supply charges when the distributor had a choice whether to incur the charge." *Id.* at A27; see p. 13, *infra*. But it concluded that "the distributors in this case cannot avoid the current take-or-pay charges," based on their past purchases, since FERC had approved those charges. Pet. App. A27-A28. The court also ob-

served that "even if in this case the filed rate doctrine permitted State review of [LDCs'] past purchasing decisions it would be difficult to say in what respect [LDCs] have been imprudent in incurring these particular costs," since the LDCs "did not know and could not have foreseen at that time that those purchasing decisions would lead to the imposition of direct-billed take-or-pay costs years later." *Id.* at A30. The court accordingly declined to address the question whether "a prudence review under these circumstances would be inconsistent with Illinois law." *Id.* at A32.

DISCUSSION

In our view, the Illinois Supreme Court misapplied the filed rate doctrine to the particular circumstances of this case, which arose out of efforts to resolve the take-or-pay problem that confronted the natural gas industry in the 1980s. We nevertheless believe that this case does not warrant further review. To our knowledge, there is no conflict among state appellate courts on the question whether the filed rate doctrine allows state regulatory commissions to prevent LDCs from passing through a portion of the take-or-pay costs they incur under FERC's orders. Because the Illinois Supreme Court expressed serious doubt as to whether disallowance of any portion of those costs would be permitted even as a matter of state law, it is unclear that an order reversing that court's ruling regarding federal law would have any effect on the ultimate outcome of the case. Finally, the sums in question here—direct charges for take-or-pay settlement costs billed by pipelines to their customers—were computed in accordance with the "purchase deficiency" method. The D.C. Circuit has struck down that method, and the Illinois court's reasoning is confined to charges based upon that method.

1. a. As noted above, FERC possesses exclusive regulatory jurisdiction over "the transportation of natural

gas in interstate commerce" and "the sale in interstate commerce of natural gas for resale." 15 U.S.C. 717(b). With respect to rates, a natural-gas company must file "schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, classifications, and services." 15 U.S.C. 717c(c). FERC has authority to determine whether the terms set forth in any such filing are "unjust, unreasonable, unduly discriminatory, or preferential," and in the event it makes such a finding, to substitute just and reasonable terms. 15 U.S.C. 717d(a); see also 15 U.S.C. 717c.

FERC's exclusive authority over the rates charged in interstate wholesale sales of natural gas has several consequences, which together have come to be known as the "filed rate doctrine." First, the parties to a transaction within FERC's jurisdiction are bound by the rate filed with or fixed by FERC. Second, that rate is binding on the courts. As this Court made clear in *Montana-Dakota Utilities Co.* v. *Northwestern Public Serv. Co.*, 341 U.S. 246, 251-252 (1951), "the right to a reasonable rate is the right to the rate which the Commission files or fixes, and * * * except for review of the Commission's orders, the courts can assume no right to a different one on the ground that, in its opinion, it is the only or the more reasonable one." See *Arkansas Louisiana Gas Co.* v. *Hall*, 453 U.S. 571, 576-579 (1981) (*Arkla*).[13] Third, FERC itself "has no power to alter a [filed] rate retroactively." *Arkla*, 453 U.S. at 578. Finally, under certain conditions, state ratemakers are required to allow interstate wholesale purchasers to recover, through the rates charged in state-regulated re-

[13] The Court noted in *Arkla*, 453 U.S. at 577 n.7, that the Natural Gas Act and the Federal Power Act, 16 U.S.C. 791a *et seq.*, draw substantially the same line between state and federal authority.

tail sales, amounts the purchasers pay pursuant to FERC-mandated rates. *Mississippi Power, supra; Nantahala, supra.*

b. This case involves the last prong of the filed rate doctrine. In the context of an ordinary arms-length purchase of electricity or gas in interstate commerce, FERC will consider, in the course of determining whether the price charged by the seller to its customers is just and reasonable, whether costs incurred by the seller (and included in the rate) were prudently incurred. FERC does not, however, review the prudence of the purchase from the buyer's (LDC's) perspective. It is established that the State's jurisdiction over rates charged in retail sales—here, between LDCs and their customers—encompasses the questions whether it was prudent for the buyer to purchase at the FERC-mandated rate and, if not, how much of the purchase price should be disallowed from the retail rates charged by the buyer. See *Kentucky West Virginia Gas Co.* v. *Pennsylvania Public Utility Comm'n*, 837 F.2d 600 (3d Cir.), cert. denied, 488 U.S. 941 (1988); *Pike County Light & Power Co.* v. *Pennsylvania Public Utility Comm'n*, 465 A.2d 735 (Pa. Commw. 1983); *Narragansett Electric Co.* v. *FERC*, 381 A.2d 1358 (R.I. 1977), cert. denied, 435 U.S. 972 (1978).[14]

FERC's exclusive jurisdiction over interstate sales for resale has different implications, however, in the case of sales of electricity among members of interstate power pools. Such pools are characterized by systemwide planning, and members of the pool are simultaneously buyers and sellers of its power. In that situation, in the exercise of its jurisdiction over interstate transactions, FERC has allocated various sources of power, some more expensive than others, among members of the pool. With respect to the power pools at issue in *Nantahala* and *Mississippi Power*, FERC entered orders that (1) allocated specified shares of high-cost or low-cost power to mem-

---

[14] See *Nantahala*, 476 U.S. at 972; *Mississippi Power*, 487 U.S. 373-374.

bers of the pools in question, and (2) fixed the rates for such power. The effect of the orders was to require members of each pool to purchase specified quantities of power from the pool at the FERC-mandated rates.

In cases such as *Nantahala* and *Mississippi Power*, a FERC order allocating the pool's power and fixing the applicable rates leaves no room for a state determination of the prudence of a pool member in its purchase of power.[15] FERC's order requires the purchaser to buy a specified quantity of power at a price FERC has determined to be just and reasonable. A State's refusal to allow the buyer to recover the amount it is thereby required to pay—on the basis of a determination that the buyer was imprudent in making the purchase—would impermissibly infringe upon FERC's exercise of its exclusive jurisdiction over interstate transactions among members of the pool.

That was the holding of *Mississippi Power* and *Nantahala*. As the Court stated in the former case, "the Supremacy Clause compels [state ratemakers] to permit [the power pool member] to recover as reasonable operating expense costs incurred as the result of paying *a FERC-determined wholesale rate for a FERC-mandated allocation of power*." 487 U.S. at 373 (emphasis added). State ratemakers "may not enter an order 'trapping' the costs [the pool member] is mandated to pay under the FERC order allocating [the pool's] power or undertake a 'prudence' review for the purpose of deciding whether to enter such an order." *Id.* at 372. The Court stressed that a State's determination that it was imprudent for the pool member to take and pay for power in accordance with FERC's orders interfered with FERC's exclu-

---

[15] That is so whether or not the issue of prudence was actually raised before FERC. *Mississippi Power*, 487 U.S. at 375. See *id.* at 379 (Scalia, J., concurring in the judgment); *Northwest Central Pipeline Corp.* v. *Kansas Corp. Comm'n*, 489 U.S. 493, 509 (1989); *Schneidewind* v. *ANR Pipeline Co.*, 485 U.S. 293, 300 (1988); *FPC* v. *Southern California Edison Co.*, 376 U.S. 205, 215-216 (1964).

sive jurisdiction: "if the integrity of FERC regulation is to be preserved, it obviously cannot be unreasonable for the [pool member] to procure the particular quantity of high-priced * * * power that FERC has ordered it to pay for." *Id.* at 374.

c. In our view, the Illinois Supreme Court mistakenly extended the rule of *Nantahala* and *Mississippi Power* to a situation in which the preconditions for its operation were not present (and in which FERC did not otherwise express an intent to preempt the challenged action by a state commission). *Mississippi Power* and *Nantahala* prohibit state regulators from finding that actions FERC required a buyer at wholesale to take were imprudent. Those holdings apply only when FERC requires the buyer to purchase a specified amount of gas or electric power at a FERC-mandated rate. Here, petitioner proposed to show that Illinois LDCs made past purchasing decisions, not required by FERC, that had increased the LDCs' subsequent liability for take-or-pay costs under the purchase deficiency method. See Pet. Ill. S. Ct. Br. 27-28. The rationale of *Nantahala* and *Mississippi Power* does not foreclose such an inquiry by a state commission.

Moreover, the Illinois Supreme Court was mistaken in its suggestion that FERC has attempted to specify the preemptive effect of its orders under the filed rate doctrine. When FERC stated in Order No. 500 that the filed rate doctrine did not preclude state regulators "from designing LDC rates, or, in appropriate circumstances, from reviewing the prudence of LDCs' purchasing decisions insofar as they affect take-or-pay costs," 52 Fed. Reg. at 30,344, FERC was not suggesting that it had the power to authorize state inquiries and determinations that would otherwise be preempted by the Natural Gas Act itself. Rather, FERC's position was that such inquiries and determinations did not, unlike the prudence review at issue in *Mississippi Power*, infringe on its statutorily mandated exclusive jurisdiction over interstate transactions. FERC's interpretation of its statutory

jurisdiction was entitled to more deference than it received from the Illinois Supreme Court.[16]

2. Although we believe that the Illinois Supreme Court erred in its application of the filed rate doctrine here, three factors independently suggest that further review is not warranted in this case.

First, to our knowledge, no other state supreme court has yet addressed the issue, and there is no conflict among state appellate courts at any level with respect to the application of the filed rate doctrine to take-or-pay costs imposed on LDCs. In *Association of Businesses Advocating Tariff Equity (ABATE)* v. *Michigan Public Serv. Comm'n*, No. 129564 (Nov. 18, 1991), the Michigan Court of Appeals agreed with the Illinois Supreme Court in this case that the filed rate doctrine entitled LDCs in Michigan to pass on their take-or-pay costs.[17] In *General Motors Corp.* v. *Public Service Comm'n*, 589 A.2d 982 (1991), the Maryland Court of Special Appeals reserved the federal preemption question, while holding that state law did not authorize disallowance of any of the take-or-pay costs from the rates charged by LDCs to their customers.[18] We are unaware of any other appellate decisions addressing the question presented by this case.[19]

---

[16] This case does not present any question concerning FERC's authority, by administrative action, to give broader preemptive effect to its orders than the Act itself (including the filed rate doctrine it embodies) requires. Compare *Fidelity Federal Savings & Loan Ass'n* v. *de la Cuesta*, 458 U.S. 141, 153-154 (1982).

[17] We have been informed by the Michigan Attorney General's Office that a request for leave to pursue a discretionary appeal from this decision to the Michigan Supreme Court is presently pending before that court.

[18] The Maryland People's Counsel informed FERC that no appeals were taken from that ruling and that the take-or-pay issue was subsequently settled before the state commission.

[19] A state trial court in South Carolina has held that the filed rate doctrine does not foreclose a state prudence review of actions rele-

Second, the decisions of the Illinois Commerce Commission and the Illinois courts indicate that petitioner has sought to raise alleged imprudence by the LDCs as the basis for requiring them to absorb a portion of the take-or-pay charges. Although it stopped short of holding that state law precludes such a showing, the Illinois Supreme Court expressed serious doubt that a prudence claim could be sustained, stating: "even if in this case the filed rate doctrine permitted State review of distribu-

---

vant to take-or-pay charges. *Hamm* v. *South Carolina Pub. Serv. Comm'n*, No. 89-CP-40-0625 (Ct. Comm. Pl., Richland County June 10, 1991). This decision relied heavily on the reasoning of the intermediate appellate decision in the instant case; it did not refer to the Illinois Supreme Court's decision, which had been issued less than a week earlier. The trial court's ruling in *Hamm* is now pending on appeal to the South Carolina Supreme Court. *Hamm* v. *South Carolina Pub. Serv. Comm'n*, No. 91-797 (argued Feb. 3, 1992). A decision of the New Hampshire Public Utilities Commission that adopted an "equitable sharing" approach requiring two LDCs to absorb 40% of their take-or-pay costs, over their objection that such an order was preempted by the filed rate doctrine (*In re Energy-North Natural Gas, Inc.*, 122 P.U.R.4th 449 (June 3, 1991), reh'g denied, 124 P.U.R.4th 160 (July 1, 1991)), is currently pending on review in the New Hampshire Supreme Court. If a substantial conflict among the decisions of state courts of last resort should develop in the future, there will be time enough for this Court to consider whether the issues presented warrant review.

A survey by FERC in 1991 found that commissions in 21 States were allowing LDCs to pass through 100% of the take-or-pay costs billed to them, while six had required LDCs to absorb some of those costs. Decisions by state ratemaking bodies illustrating some of the approaches adopted include: *In re Northern Indiana Public Serv. Co.*, 97 P.U.R.4th 1, 4-7 (Ind. U.R.C. 1988) (authorizing full pass-through of take-or-pay costs); *In re Planning Review, Rate Design, Purchased Gas Adjustment Clauses, Accounting, and Related Matters for Natural Gas Distribution Utilities*, 99 P.U.R.4th 253 (Wisc. P.S.C. 1989) (holding that while federal preemption does not preclude a prudence review, such a review would serve little purpose under the circumstances present in Wisconsin); *In re Southern California Gas Co.*, 109 P.U.R.4th 1, 31-34 (Cal. P.U.C. 1990) (providing for equitable sharing of take-or-pay costs); *In re Delmarva Power & Light Co.*, 116 P.U.R.4th 287 (Del. P.S.C. 1990) (authorizing pass-through of take-or-pay costs).

tors' past purchasing decisions, it would be difficult to say in what respect distributors have been imprudent in incurring these particular costs." Pet. App. A30. The court added that "unless clairvoyance has become an element of prudence, there simply is no basis on which the [Illinois Commerce Commission] could conduct a meaningful prudence review." *Id.* at A31. The nature of the actions that might warrant holding an LDC responsible for a portion of direct take-or-pay charges is an issue of state law. Thus, there is serious reason to question whether a ruling by this Court reversing the Illinois Supreme Court's decision and remanding for consideration of the issues identified by the intermediate appellate court (Pet. App. A64) would have any effect on the ultimate outcome of this case.

Third, the take-or-pay charges that were the subject of the Illinois Commerce Commission's proceeding, and thus of the Illinois Supreme Court's decision, were fixed, direct charges computed in accordance with the "purchase deficiency" method. See Pet. App. A88 (Illinois Commerce Commission's order addressing "direct billed past take-or-pay costs"). As we have noted, the D.C. Circuit held in *Associated Gas Distributors* v. *FERC*, 893 F.2d at 355, that use of the purchase deficiency method violates the filed rate doctrine. As a result of the D.C. Circuit's decision, FERC issued its Order No. 528, which stayed the effectiveness of most pipeline tariffs that incorporated the purchase deficiency method. The only tariffs excluded from that stay were those, including settlements, that FERC had approved in orders that became final and nonappealable prior to the issuance of the D.C. Circuit's mandate. Although none of the decisions below addresses the point, it appears that the D.C. Circuit's opinion will affect most, if not all, of the direct-billed charges at issue in this case, and therefore will require that take-or-pay charges be passed on by interstate pipelines to Illinois LDCs by some other method.

Order No. 528 does not prescribe any single methodology to replace the purchase deficiency method. Rather,

it gives interstate pipelines and their customers flexibility to design cost-allocation mechanisms. Order No. 528 lists several examples of "acceptable allocation methods" by which pipelines may seek to recover costs that previously could have been recovered by means of a fixed charge computed pursuant to the purchase deficiency method. These include fixed charges based upon some current measure of demand or usage (such as contract demand, peak demand, or actual throughput); volumetric surcharges; some combination of fixed charges and volumetric surcharges; or any agreed-upon methodology consistent with FERC's general principles.[20]

The Illinois Supreme Court's reasoning with respect to the filed rate doctrine is limited to direct charges computed using the purchase deficiency method. In the court's view, *Nantahala* and *Mississippi Power* were controlling here because the take-or-pay charges imposed on the LDCs were based upon the LDCs' past purchasing decisions and thus could not have been avoided. See Pet. App. A26-A30. In its brief in opposition in this Court (at 11-12), the Illinois Commerce Commission represents that its "preemption analysis," which was affirmed by the Illinois Supreme Court, "was confined * * * to recovery of direct-billed, FERC-allocated costs." Similarly, the legal analysis in another of the briefs in opposition emphasizes that the charges in question were computed on the basis of past sales, acknowledging that a different analysis might be appropriate for take-or-pay charges that are included (as Order No. 528 allows) in the costs

---

[20] Order No. 528, 55 Fed. Reg. at 47,865-47,867. The four principles FERC adopted in Order No. 528 are that (1) the costs should be spread as broadly as possible so that "all segments of the industry—pipelines, producers, LDC's, industrial end-users, and other consumers—should contribute to funding the pipelines' take-or-pay costs"; (2) pipelines should absorb a significant proportion of the costs; (3) "captive sales customers—namely residential and small commercial gas users—should not bear a disproportionate share of take-or-pay costs"; and (4) pipelines and producers should abide by existing settlement agreements. *Id.* at 47,865-47,866.

of *current* gas purchases, which could be avoided by an Illinois LDC that was able to purchase cheaper gas elsewhere. Northern Illinois Gas Co. Br. in Opp. 12-13, 16-17.[21]

For present purposes, the D.C. Circuit's decision in *Associated Gas Distributors* invalidating the purchase deficiency method has two significant consequences. First, it is unclear to what extent there remains a live controversy over the application of the filed rate doctrine to direct-billed charges computed in accordance with that method, either in Illinois or elsewhere. Second, a decision by this Court addressing that issue would have limited prospective significance, because FERC Order No. 528 now requires new methods for allocating past take-or-pay costs (except where a FERC order approving an allocation based on the purchase deficiency method had already become final). Moreover, any ruling by this Court concerning the scope of the filed rate doctrine in this case might be of limited precedential significance outside the unique context of the allocation of past take-or-pay costs through fixed charges. For these reasons, and in the absence of any conflict among state supreme courts, it is our view that this issue does not now warrant this Court's review.

---

[21] In the Illinois Supreme Court, certain respondents argued that the D.C. Circuit's decision in *Associated Gas Distributors* would not affect the unavoidability of the take-or-pay charges that might be computed under methods supplanting the purchase deficiency method. Peoples Gas Light & Coke Co. Ill. S. Ct. Br. 11 n.4.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

KENNETH W. STARR
Solicitor General

EDWIN S. KNEEDLER
Assistant to the Solicitor General

STEPHEN L. NIGHTINGALE
Assistant to the Solicitor General

WILLIAM S. SCHERMAN
General Counsel

JEROME M. FEIT
Solicitor

RANDOLPH LEE ELLIOTT
Attorney
Federal Energy Regulatory Commission

APRIL 1992

☆ U. S. GOVERNMENT PRINTING OFFICE: 1992 312324 45383